Joachim Wuermeling: Current challenges in Europe – a central banker's perspective

Speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the Money Marketeers of New York University, New York City, 29 March 2018.

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1 Introduction

Ladies and gentlemen

Thank you very much for inviting me to speak to you here on Wall Street – any self-respecting central banker would jump at the chance to greet an audience on the world's most renowned street of money and finance at least once during their career!

I was fascinated to learn that Wall Street got its name from a protective wall built back in the 17th century, and that the New York Stock Exchange was founded there in the late 18th century. It's remarkable that a protective wall has come to be synonymous with an open global financial centre where people from all over the world meet and do business together.

Despite its name, Wall Street has never benefited from walls. Quite the opposite, in fact: it has profited from tearing down walls, from eliminating tax barricades and trade barriers.

There are three topics I would like to emphasise in my speech today that all have something to do with walls: First, I would like to offer an outlook on the current political situation in Germany and Europe. As you all know, Germany benefited tremendously – almost 30 years ago now – from a certain wall being torn down, with the help of our European and American friends. Second, I would like to touch upon monetary policy and economic developments in the euro area, and I am sure that the ECB's decisions on monetary policy that might be in the pipeline will have an effect on Wall Street. Third, I would like to share a few thoughts on free trade, and on the difficulties and risks posed by walls and barriers in our globalised economies.

2 Current political situation in Germany and Europe

Looking at what the media say about Europe these days, you might be forgiven for thinking that the "old continent" is hurtling towards chaos. A headline of the New York Times springs to mind, which read: "Chaos in Catalonia". The Huffington Post wrote about the "Brexit chaos". And the Washington Post fears that the EU might even cease to exist: "What the E.U. must confront if it wants to survive".

Let me assure you: the future of Europe is not really on the rocks, despite what these headlines might suggest. It is typical for open democratic societies to go from one political controversy to the next. There is no need to badmouth democratic discourse as chaos.

Recent events in Germany are a good example. There, it has taken quite a while to form of a coalition – longer than ever before in post-war German history, in fact. However, the government remained functional at all times. And even more importantly, an anti-European course was never on the cards, no matter what coalition was formed.

This also explains the market response: one might think that the situation in Germany would be perceived as a threat to the economy and that it would therefore send the DAX lower. But the opposite was the case: unlike the reaction to France's presidential elections in 2017, the market responses to the recent elections in Germany and Italy appeared more benign. This also goes for Catalonia. We see this as a good sign. In the Bundesbank's view, market participants are acknowledging that economic stability is returning to much of the euro area and that eurosceptic

tendencies will be manageable. So you see: Current European political processes do not have an overwhelming impact on economic developments, and the markets have learned to differentiate between actual crises and political controversies.

However, now that a new German government has been formed, the reform process in the euro area does need to gain speed. In mid-March, on the very day the new federal cabinet took office, the new German Foreign Minister Heiko Maas immediately travelled to Paris to “seize Macron’s outstretched hand”, as he said. Angela Merkel also promptly travelled to Paris following her re-election in the Bundestag.

France and Germany have traditionally been key players in the process of reforming European economic and monetary union. We see a clear desire on both sides, in France and in Germany, to foster reforms. Merkel and Macron have announced a joint roadmap for reforming the euro area, which they intend to present to their European peers in June. However, negotiations will undoubtedly be long and arduous, especially when it comes to minimising risk – which is what the Bundesbank is suggesting – or sharing risk, which is what some other ideas imply.

All the reform plans touch upon a key question for Europe: what shape should the EU’s political system take? To what extent do we see the EU as an international, intergovernmental institution, to what extent is it a regime in its own right? The EU has always been a system “sui generis” – a set-up unlike any other, which means, it has always been subject to change. The underlying question is this: which competencies need to be at the EU level, which should be kept at the intergovernmental level and which at the national level?

In my opinion, before we plan any concrete reforms, we first need a clear economic and political analysis of past crises: to better understand what led to the crises, and to identify, from today’s perspective, which policy measures worked, and which ones didn’t. Building on these insights, we can design tailor-made reforms.

From my point of view, there are three key questions we have to discuss and resolve:

First, there is the conditionality of cross-European support as an underlying principle. We have the Stability and Growth Pact which sets out the fiscal surveillance rules and limits for government deficits and debt. In the Bundesbank’s opinion, monitoring activities under the Stability and Growth Pact should be independent of political institutions, if the assessment is to be a neutral one. For example, the European Stability Mechanism could give such an assessment. Currently, there are debates about reforming the ESM into a “European Monetary Fund”, which might also provide assistance in times of asymmetric economic shocks. In the Bundesbank’s view, it is important to grant financial assistance only subject to proper conditionality. If support is granted with no strings attached, as it were, fiscal stability and responsible budgetary policies will be undermined.

Second, we need to sever the sovereign-bank nexus. In the recent crises, struggling sovereigns brought banks to their knees, because European banks hold quite substantial stocks of domestic sovereign bonds on their balance sheets. But the nexus worked in the other direction as well: struggling banks needed government assistance. We need to fix this “doom loop”. Serving as a backstop for the Single Resolution Fund, the European Monetary Fund could help in taking sovereigns out of the liability cascade. Such a fiscal risk sharing would, however, require a further reduction of legacy risks in bank’s balance sheets. However, we need further steps. The Bundesbank is proposing to reconsider the regulatory treatment of government bonds on bank balance sheets. We are calling for a phasing-out of the current zero-risk weighting and exposure limits for government bonds.

Third, we have to find a way to make private risk sharing more effective in the euro area. In the US, about 65 % of an economic shock in one state is cushioned by private risk sharing in the form of cross-border loss sharing and cross-border borrowing. In the euro area, the percentage

is far lower. The capital markets union currently under discussion could tear down walls in Europe's capital markets. This could enhance private risk sharing and therefore make the euro area more resilient to crises.

These are just three glimpses at the debate surrounding the complex issue of reforming European economic and monetary union. Currently, looking at the new governments in France and Germany, we have a "window of opportunity" for reforms, before the elections to the EU Parliament in May 2019 and the election of a new President of the European Commission. However, moving ahead with reforms is not a no-brainer, as different opinions from all member states have to be considered.

You will have the opportunity to discuss our ongoing reform process in greater detail with François Villeroy de Galhau, the Governor of the Banque de France, when he meets you in mid-April.

3 Monetary policy and economic developments in the euro area

The time is right for reforms in Europe. John F Kennedy said that "the best time to repair the roof is when the sun is shining". Jean-Claude Juncker quoted these famous words when he presented the Commission's reform proposals.

And we can definitely say the sun is currently shining. We are observing a broad-based economic recovery in the euro area. The latest ECB staff projection forecasts real GDP growth of 2.4 % in 2018, of 1.9 % in 2019, and of 1.7 % in 2020. This is partly based on significant structural reforms undertaken by several countries. However, given the subdued inflationary pressure in the euro area, an accommodative monetary policy stance remains appropriate.

In January, the ECB Governing Council dropped its "easing bias", as it is known – a long-standing pledge to extend its asset purchases if necessary. In the Bundesbank's view, the upbeat economy and the inflation forecast would justify bringing the net asset purchases to a rapid end, if the economic recovery in the euro area continues as expected. In a similar vein, market participants are expecting an end until the end of this year. Further decisions are to come in the course of the year.

Of course, we at the Bundesbank are keeping a close eye on monetary developments in the US, given the process of policy normalisation. Here, also given the substantial fiscal stimulus, inflationary pressures are finally building up. For now, market participants are expecting the Fed to continue the process of gradually normalising policy. At the same time, Fed watchers are noting the new Fed Chair's language that "headwinds are shifting to tailwinds". This is also what Lael Brainard, Member of the Board of Governors of the Federal Reserve System, said at this place just three weeks ago.

4 Remarks on free trade

To some extent, the economic outlook for the US and the euro area, and thus its monetary policy, will be influenced by trade policy. On the one hand, investors await the outcome of the Brexit negotiations. On the other, investors are uncertain about what the future holds for the "bilateral dealmaking" approach to US trade policy and its interplay with international trade partners.

During the post crises economic expansion, WTO members have imposed over 2,000 new trade barriers. This rise in protectionism and the growth in trade restrictions – new walls – are in our view downside risks to the growth outlook. And the markets agree with that judgement, as the market responses to the US tariffs have shown.

The Bundesbank is convinced that open markets are important for a dynamic global economy. At

the G20 meeting in Buenos Aires last week, the new German Minister of Finance, Olaf Scholz, also underlined the importance of open markets.

Openness in trade delivers many benefits: we have larger markets and can therefore better exploit economies of scope and scale. A greater division of labour creates more opportunities for specialisation. Technology and innovation diffuse across borders more quickly. And fiercer competitive pressure can drive up productivity.

Free trade is almost always a boon for a country's entire economy. But not everyone will necessarily derive personal benefits from open markets. After what we have experienced, we need a serious debate about the positive and negative impact, and especially the redistributive effects which global cooperation is having on our societies.

But new walls and protectionism cannot be the answer. Instead, we need to focus on making global growth even more inclusive. William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, recently delivered a speech entitled: "Making globalization work". That is exactly what we have to do, and I am pleased to note that the central banks around the world seem to agree on this point.

In Europe, free trade might become more restricted exactly one year from now when the UK leaves the EU. Last week, the UK and the EU agreed on terms for a 21-months Brexit transition period. For the EU, Brexit is manageable from an economic viewpoint. But we should prepare for different scenarios, even if the talks between the UK and the EU made progress recently, because negotiations on a trade agreement are still to come.

Another factor restricting free trade comes in the form of the protective tariffs which the United States partly applied last week – and in the form of the potential response from trading partners. Mario Draghi said at the most recent ECB press conference: "If you put tariffs against your allies, one wonders who the enemies are."

In my opinion, we should be thinking not about new walls, but about fresh forms of cooperation. Brexit, for example, could be a trigger for the financial centres in the EU 27 to focus more on cooperation than on rivalry.

Today, the EU 27's overall potential is spread over various locations and has not yet had a cumulative impact. Physical distance has – up to now – prevented EU financial centres from being globally competitive. However, geographical proximity is becoming less important for a financial centre – provided we harness the new technological potential. Digitalisation opens up a totally new perspective for the EU 27's financial centres: to pool their potential and cooperate as a single digital financial centre – not as a replica of old systems, but as a highly innovative technical project.

To chart a course for a single "Digital City of Europe", as this project might be called, the financial centres will need to specialise and cooperate, build up a competitive digital infrastructure, and offer a harmonised, perhaps even a common legal framework. Policymakers can act as a catalyst for this "Digital City of Europe". But of course, market players are the ones who will have to build up and accept a "digital financial markets union" of this kind.

5 Conclusion

Ladies and gentlemen

Let me sum up my three key points today:

First, I see the need to reform European monetary and economic union. Our focus should be on how to prevent and to overcome crises in the future, and we have to make sure we carry out

tailor-made reforms that tackle the actual problems that came to light during the last crises.

Second, the broad-based economic recovery in the euro area is increasing the likelihood of an adjustment in monetary policy.

Third, I fear the rise of barriers to free trade and open markets, in spite of our empirical and theoretical evidence that free trade is almost always a boon for a country's entire economy.

As you can tell, I firmly believe in tearing down walls and not erecting any new ones. Wall Street shows the way forward: it made a name for itself by doing away with its protective wall, and by facilitating trade on the city's stock exchange.

Just like New York, Berlin also got a protective wall in the 17th century, with a gate that has since become iconic: the Brandenburg Gate. Remarkably, the Brandenburg Gate was part of the customs wall. In other words, it was a symbol of economic protectionism. During the Cold War, it became a symbol of the conflict between East and West. In 1987, the then US president Ronald Reagan chose that very site to challenge his Soviet counterpart Mikhail Gorbachev with the words: "If you seek peace, if you seek prosperity […], if you seek liberalisation, […] tear down this wall!"

Bearing this in mind, we would all be better off if we avoided raising any new walls – and that goes just as much for the United States as it does for Europe.

Thank you for your attention.